Internal Revenue Service

# memorandum

CC:TL-N-9978-90
Br2:LSMannix

date: NOV 28 1990

to: District Counsel, [redacted] CC:PHI
Attn: [redacted]

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: Special Legislation enacted by TAMRA with respect to [redacted]

This responds to your request for advice concerning the effect of section [redacted] of the Tax Reform Act of 1986 (hereinafter referred to as the "Tax Reform Act"), which was amended by section [redacted] of the Technical and Miscellaneous Revenue Act of 1988 (hereinafter referred to as "TAMRA"). This case is presently in Examination.

ISSUES

1. Does section [redacted] of the Tax Reform Act, as amended by TAMRA, preempt the requirement for Park Service certification in order that the expenditures in question may qualify as "qualified rehabilitation expenditures" under I.R.C. § 48(g)?

2. Does section [redacted] of the Tax Reform Act, as amended, permit otherwise nonqualifying costs, e.g. those made in connection with roadway and parking lot construction, landscaping and demolition, to qualify as qualified rehabilitation expenditures?

3. Does section [redacted] of the Tax Reform Act, as amended, require the Service to accept without challenge the projected expenses of development and not inquire as to their reasonableness, with the only recourse being the recapture of the excess not expended under section [redacted] of the Tax Reform Act, as amended? (You assert that the statute would appear to require a contract for the expenses to be allowed but there was no contract in place as of [redacted] with an unrelated party; rather there was a "Rehabilitation and Redevelopment Coordination Agreement" between [redacted] and a corporation wholly owned and controlled by [redacted].)

4. What recourse does the Service have under section 251(d) of the Tax Reform Act, as amended, to recapture the rehabilitation credit under I.R.C. § 47 if a partner transfers (by death or otherwise) his interest prior to 1993?

5. Does section [redacted] of the Tax Reform Act, as amended, prohibit the Service from examining the contents of the projected expenditures to determine whether there are hidden nondeductible items included therein such as development, syndication or organizational expenditures?

6. Should the basis reduction requirement of Treas. Reg. § 1.48-12(e) be applied to the total of the expenses allowable as a deduction in [redacted]?

7. Does section [redacted] of the Tax Reform Act, as amended, abrogate the otherwise applicable basis and at-risk limitations with respect to the amount of loss deduction which may be taken by each individual investor in [redacted]? According to your request, the projected flowthrough loss from [redacted] far exceeds each investor's basis. Your request also states that the investors have been advised by the promoter of [redacted] that they are entitled to take their allocable partnership losses without limitation in [redacted].

8. How may the Service be protected, or what recourse does it have, in the event that an individual investor dies or disposes of the partnership interest prior to 1993 in order that the recapture provisions provided under section [redacted] of the Tax Reform Act, as amended, may be timely and properly implemented?

9. How are the words "tax benefit" in section [redacted] of the Tax Reform Act, as amended, to be interpreted and how is such tax benefit to be computed?

10. Administratively, how is section [redacted] of the Tax Reform Act, as amended, to be implemented? Must you advise the District Director to retain the returns of each individual investor for the years [redacted] through [redacted] so that the "tax benefit" can be properly verified? Also, is the "tax benefit" a partnership item which would be recaptured pursuant to the issuance of a notice of a final partnership administrative adjustment (referred to as the "FPAA") or is it a nonpartnership item which would be subject to the normal deficiency procedures?

## GENERAL CONCLUSION

Generally, we conclude that Congress intended for investors in the [redacted] to claim both current deductions and rehabilitation credits for all projected expenditures, including expenditures that normally would not be "qualified rehabilitation expenditures," paid or incurred to improve the [redacted]. We also conclude that certification from the Secretary of the Interior is not required in order to claim these tax benefits. Although such

treatment appears abusive, we conclude that no other reasonable interpretation is possible under section [redacted] of the Tax Reform Act, as amended.

FACTS

According to your request for advice, the facts are as follows.

Examination is currently examining the [redacted] taxable year of a limited partnership called [redacted]. The general partner of [redacted] is [redacted]. [redacted] has four limited partnerships as its limited partners which are called [redacted], [redacted], [redacted] and [redacted] (hereinafter referred to as the "[redacted] partnerships"). The [redacted] partnerships, in turn, have various individual investors as their limited partners. The [redacted] partnerships have a common corporate general partner which is owned by the general partner of [redacted], [redacted].

[redacted] was formed to acquire, rehabilitate and operate as light industrial and office space a complex of buildings known as the [redacted] (hereinafter referred to as the "[redacted]"). The [redacted] is listed in the National Register of Historic Places. Its development and operation have been represented as providing a great economic boost to the area of [redacted] where it is situated.

[redacted] has filed a request for administrative adjustment (RAA) for its [redacted] taxable year, claiming, on behalf of its partners, a huge rehabilitation credit and expense deduction for that year based on section [redacted] of the Tax Reform Act, as amended. Pursuant to section [redacted], [redacted] submitted its projection of the expenditures to be incurred from [redacted] through [redacted] in support of its claim. Furthermore, it has included expenditures in its projection which would ordinarily not qualify as rehabilitation costs under I.R.C. § 48(g)(2); e.g. road and parking lot construction, demolition, landscaping and other site work.

[redacted] has not received certification from the Park Service for the rehabilitation of the [redacted]. In fact, in early [redacted] the Park Service initially rejected [redacted] rehabilitation proposal (the Park Service objected to the demolition of certain buildings and made suggestions which, if followed, would result in certification being granted). After having received that rejection, [redacted] made no further contact with the Park Service regarding certification. [redacted] apparent abandonment of its efforts to have the complex certified coincided with the passage of TAMRA.

[redacted] claims that section [redacted] of the Tax Reform Act, as amended by TAMRA, obviates the need for certification.

At this time, [redacted] is pressuring Exam to approve its RAA, thereby paving the way for refunds to the limited partners of the [redacted] partnerships, most of whom have filed 1040X's based on the RAA.

According to your request, Exam believes that the projected expenditures for the rehabilitation of the [redacted] are exaggerated. Exam notes that [redacted] does not have financing in place to fund the amount of projected expenditures and that the projections include a sizeable commission payable to [redacted]'s controlled entity with whom the "contract" was made. According to your request, Exam is inclined to deny the RAA.

Exam has asked you for technical and legal advice with respect to the above listed issues. You have requested our advice with respect to these same issues.

DISCUSSION

In 1986, Congress amended the rehabilitation credit sections of the Code effective for property placed in service after December 31, 1986. Tax Reform Act of 1986 (the "Tax Reform Act"), Pub. L. No. 99-514, § 251, 100 Stat. 2183 (1986). At the same time, Congress also enacted certain transitional rules. Section [redacted]

[redacted]

[redacted]

The House Ways and Means Committee Report [redacted] the [redacted] project and the effect of the amendments to the rehabilitation credit and the transitional rules on it. [redacted]. The Committee intended the general transitional rules to apply and, thus, did not mention the [redacted] by name in the bill it submitted to the full House. [redacted].

[redacted]. However, the Senate Finance Committee adopted a specific transitional rule for the [redacted] project in its bill, mentioning the [redacted] by name in the bill but not in its Report. [redacted]. The Conference Committee Report states that the Conferees would follow the Senate amendments to the House bill. [redacted]. Thus, the Senate's version of the transition rule for the [redacted] was finally adopted. As stated above, section [redacted] allows the owners of the [redacted] to take advantage of the rehabilitation credit as it existed prior to the Tax Reform Act even though the property will be placed in service after [redacted].

The House Ways and Means Committee Report and corresponding bill also states that for property subject to any of the transitional rules, the "rehabilitation percentage," under I.R.C. § 46(b)(4), is reduced for all types of "rehabilitation buildings," as defined in section 48(g)(1). H.R. Rep. 426, at 189, 1986-3 vol. 2 C.B. at 189; H.R. 8383 (as reported by the House Ways and Means Committee), § 323(d)(6). The Senate Finance Committee Report and corresponding bill contain substantially the same language, except the Finance Committee exempted out the [redacted] project from the effect of the rehabilitation percentage reduction. [redacted]; [redacted]. However, both the House and Senate committee provisions were altered by the Conferees. Under section [redacted] of the Tax Reform Act, the reduction in the rehabilitation percentage for property falling within the scope of the transitional rules does not apply to "certified historic structures," as defined in 48(g)(3). Rather, the rehabilitation percentage for the rehabilitation of "certified historic structures" that fall within any of the transitional rules, which includes the [redacted], remains at 25%.

The transitional rules for the rehabilitation credit and the current deduction granted to [redacted] in the Tax Reform Act of 1986 was apparently not to the satisfaction of those concerned and corrections were submitted to the Congressional committees almost immediately after their enactment. On [redacted], Congressman [redacted], who represents [redacted], wrote a letter to [redacted], Assistant Secretary of the Treasury (Tax Policy), asking him to treat pending technical corrections (which were, in part, substantially similar to what was finally enacted as part of TAMRA) as if it were law. This would allow investors and would-be investors to rely on the proposed

corrections. In a letter dated [redacted], Mr. Mentz denied Congressman [redacted]'s request.

However, in Mr. Mentz's letter to Congressman [redacted], he stated the effect of the proposed technical corrections. His letter states:

> In summary, the proposed technical correction would permit the owners of the [redacted] to treat any expenditures to be made to rehabilitate the [redacted] during the [redacted] period between [redacted] and [redacted] as if made in [redacted], and would allow both the 25-percent rehabilitation tax credit and a current deduction in [redacted] with respect to such expenditures.

The technical corrections to section 251(d) of the Tax Reform Act with respect to the [redacted] were finally passed in 1988. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. 100-647, § 1002(k)(4), 102 Stat. 3372 (1988). The statute states in full:

[redacted]

[redacted][1]

[redacted]

[redacted]

[redacted]

[redacted]

No legislative history to the corrections made by TAMRA with respect to the [redacted] has been found, other than the letters between Congressman [redacted] and Mr. Mentz. However, as a preliminary matter, it should be noted that the TAMRA legislation does not replace section [redacted] of the Tax Reform Act but, rather, only section [redacted]. Thus, section [redacted], as discussed above, is still effective and should be read together with the TAMRA legislation. It should also be noted that section [redacted] of the Tax Reform Act, as amended by TAMRA, is set in the context of the amendments to the rehabilitation credit provisions of the Code and, in fact, refers to such provisions either expressly or implicitly and, at certain points, by using the same terms as are used by certain rehabilitation credit Code provisions, e.g. see the term "qualified rehabilitation expenditure" in section [redacted] of the Tax Reform Act, as amended, and in I.R.C. § 48(g)(2)(A). This supports the argument that unless superseded by section [redacted] of the Tax Reform Act, as amended, the normal rules with respect to the rehabilitation

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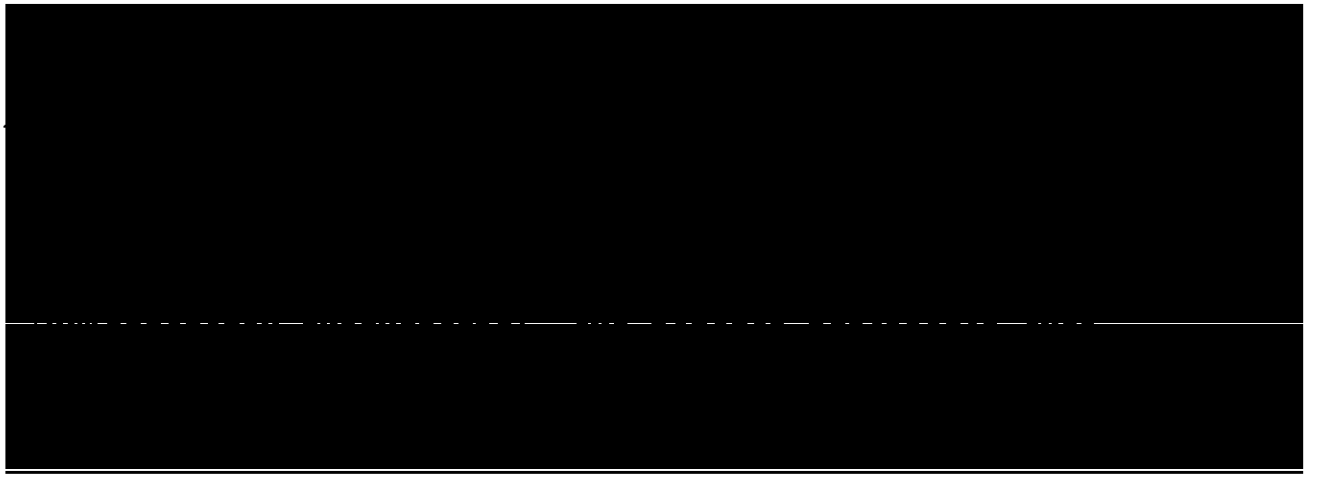
[1] The form and tense of subparagraph (i), (ii) and (iii) is grammatically incorrect no matter what interpretation of subparagraphs (i), (ii) and (iii) is attempted. The most likely correction considering Congress' most probable intended meaning is as stated.

credit provisions and, for that matter, any other Code provision or rule of law apply to the rehabilitation of the [redacted].

Issue 1:

Section 48(g)(2)(A) defines a "qualified rehabilitation expenditure" as any amount properly chargeable to capital account which is incurred after December 31, 1981--...in connection with the rehabilitation of a qualified rehabilitation building." Section 48(g)(2)(B) states that the term "qualified rehabilitation expenditure" does not include "[a]ny expenditure attributable to the rehabilitation of a certified historic structure or a building in a registered historic district, unless the rehabilitation is a certified rehabilitation (within the meaning of subparagraph (C)). Section 48(g)(2)(C) states: "For purposes of subparagraph (B), the term 'certified rehabilitation' means any rehabilitation of a certified historic structure which the Secretary of the Interior has certified to the Secretary as being consistent with the historic character of such property or the district in which the property is located." This statutory outline shows that certification from the Secretary of the Interior is one of the requirements necessary to qualify an expenditure for the rehabilitation of a certified historic structure as a "qualified rehabilitation expenditure." In other words, certification is part of the definition of "qualified rehabilitation expenditure."



This reading of the statute is consistent with the well established principle of statutory interpretation that "...effect must be given, if possible, to every word, clause and sentence of a statute." Sutherland Stat. Const. § 46.06 (4th Ed.), citing State v. Bartley, 39 Neb. 353, 58 N.W. 172 (1894). Taking the position that certification is, nevertheless, necessary would effectively read section [redacted] of the Tax Reform Act, as amended, out of the statute. Congress would have had no other reason for putting the subparagraph in the statute other than to

qualify the expenditures as "qualified rehabilitation expenditures" because subparagraph (A) would have been sufficient to give investors in the [redacted] a credit in [redacted] if the expenditures otherwise qualified. The position that certification would be necessary, therefore, is insupportable under the rules of statutory interpretation. Furthermore, there is no evidence that Congress intended only some of the requirements for "qualified rehabilitation expenditures" to be superseded but not others and, thus, to read such a meaning into the statute would also be without support.

It should also be noted, although it is not entirely clear, that Congress must have meant the investors in the [redacted] to claim the rehabilitation credit in [redacted]. [2] Otherwise, the investors could not claim the credit at all. The following analysis will illustrate.

Section 46(a)(3) states that, for purposes of section 38, the investment credit includes the amount of the "rehabilitation percentage" [3] of a "qualified investment" in "that portion of the basis of any property which is attributable to qualified rehabilitation expenditures...." Section 46(c)(1)(A) defines a "qualified investment" as the "applicable percentage ["rehabilitation percentage" in this case] of the basis of each new section 38 property...placed in service by the taxpayer during the taxable year...." Section 48(a)(1)(E) defines "section 38 property" as "in the case of a qualified rehabilitation building, that portion of the basis which is attributable to qualified rehabilitation expenditures...." [4] Section 48(g)(1)(A)(i) defines the term "qualified rehabilitation building" as, among other requirements, "any building which has been substantially rehabilitated." [5] Section 48(g)(1)(C) states

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[2] It is clear, however, that section [redacted], of the Tax Reform Act, as amended, gives the investors in the [redacted] a deduction in [redacted] for all projected expenditures to be made from [redacted] through [redacted].

[3] As stated above, the "rehabilitation percentage" is 25% for "certified historic structures," that fall within the transitional rules in section [redacted]. See Section 46(b)(4)(A).

[4] Section 48(g)(4) states that property that qualifies as "section 38 property" under section 48(a)(1)(E), shall be treated as "new section 38 property." (Emphasis supplied.)

[5] It is clear that the [redacted] was originally placed in service before the current rehabilitation project and, thus, the requirement of section 48(g)(1)(A)(ii) is met. Furthermore, the

that "a building shall be treated as having been substantially rehabilitated only if the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer (at the time and in the manner prescribed by regulations) and ending with or within the taxable year exceed the greater of-- (I) the adjusted basis of such building (and its structural components), or (II) $5,000." For "phased rehabilitations," as defined in section 48(g)(1)(C)(ii), "60-month period" is substituted for "24-month period."

The above statutory outline shows that in order to claim the rehabilitation credit, the expenditures for the 24-month period (or, in some cases, the 60-month period) ending in the year the credit is claimed must exceed the greater of the adjusted basis of the property or $5,000. Under section [redacted] of the Tax Reform Act, as amended, all the expenditures for the [redacted] are to be treated as made in [redacted]. Thus, under section [redacted] of the Tax Reform Act and section 48(g)(1)(C), the [redacted] would be deemed to be "substantially rehabilitated" in [redacted], assuming the projected expenditures exceed the greater of the adjusted basis of the property or $5,000.

However, the above statutory outline also shows that generally the credit can only be claimed in the year the property is "placed in service." Section 46(c)(1)(A). It is unlikely that any of the buildings or any significant portion of the buildings that make up the [redacted] were placed in service in [redacted] and, thus, it would appear that the investors in the [redacted] could not claim a credit until some later year. Furthermore, the property will most likely be placed in service in excess of either [redacted] or [redacted] months after [redacted]. Thus, when the property is finally placed in service, the investors in the [redacted] could not meet the "substantially rehabilitated" test discussed above. In any event, there would be no expenditures upon which to base the credit--no expenditures having been paid or incurred within the preceding 24 or 60 month period. See Treas. Reg. § 1.48-12(c)(6). Thus, the investors in the [redacted] would again be unable to claim the credit.

This is clearly not what Congress intended. Because Congress expressly stated that the expenditures made in connection with the [redacted] are deemed paid or incurred in [redacted], Congress must have intended the investors in the [redacted] to claim

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last sentence of Treas. Reg. § 1.48-12(b)(1) states that the requirement of section 48(g)(1)(A)(iii) does not apply to certified historic structures. Thus, the only requirement with respect to whether the [redacted] is a "qualified rehabilitated building" is that the [redacted] has been "substantially rehabilitated."

the rehabilitation credit in [redacted]. Otherwise, the statute would not work and, as stated above, statutes must be interpreted to give them effect. In this context, it should be noted that in Mr. Mentz's letter to Congressman [redacted], he assumed the credit would be available in [redacted]. See text of letter quoted above.

Finally, it should also be noted that there is a mechanism for claiming a credit before property is placed in service. Section 46(d) allows taxpayers to claim investment credit on "qualified progress expenditures" made with respect to "progress expenditure property" in years prior to the year the property is placed in service. Treas. Reg. § 1.48-12(f)(2) makes clear that the rehabilitation credit can be claimed on "qualified progress expenditures" as well. Section 46(d)(2) defines "progress expenditure property" as "any property which is being constructed by or for the taxpayer and which--(i) has a normal construction period of two years or more, and (ii) it is reasonable to believe will be new section 38 property in the hands of the taxpayer when it is placed in service." It appears that the [redacted] will take longer than 2 years to rehabilitate and, as stated above, all rehabilitated property is considered "new section 38 property," under section 48(g)(4). Thus, the [redacted] also fits the definition of "progress expenditure property" and, therefore, [redacted] could claim a credit in [redacted] under section 46(d).

Issue 2:

Sections [redacted] of the Tax Reform Act, as amended, state that "any expenditures paid or incurred in connection with improvements (including repairs and maintenance) of the [redacted]...shall...(B) be treated as qualified rehabilitation expenditures...." This language is markedly different from the language used in section 48(g)(2) to define "qualified rehabilitation expenditures." For example, section 48(g)(2) narrowly defines qualifying expenditures as, among other things, expenditures made "in connection with the rehabilitation of a qualified rehabilitation building." Section [redacted] does not require that the expenditures be made to "rehabilitate" the [redacted] but rather merely to "improve" it. Furthermore, section [redacted] states that "any" expenditures, including repairs and maintenance, qualify as "qualified rehabilitation expenditures." This is also broader than section 48(g)(2), which requires that qualifying expenditures be properly chargeable to the capital account of the taxpayer. Thus, the thrust of section [redacted] is that expenditures that ordinarily would not qualify shall be treated as "qualified rehabilitation expenditures."

Because of the liberal language used in section [redacted] of the Tax Reform Act, as amended, and because section [redacted] supersedes section 48(g)(2), as discussed above, we conclude that

the expenses you have listed are "qualified rehabilitation expenditures."

However, it should be noted that the cost of acquiring the [redacted], or any part therein, is not a "qualified rehabilitation expenditure," under section [redacted] of the Tax Reform Act, as amended, because such an expenditure was not paid or incurred to "improve" the [redacted] but rather merely to purchase it. The same is true with respect to expenditures incurred to enlarge the [redacted] or any of its buildings. This is consistent with sections 48(g)(2)(B)(ii) and (iii).

Issue 3:

Unless the projected expenditures can be shown to be so wildly exaggerated as to be clearly excessive, we recommend not challenging the projections. First, it is unclear what standard of review would apply. Would the standard be that the projections must be reasonably accurate with leeway given for unforeseen expenditures that almost always occur in major construction projects? Second, under any standard, an inquiry into whether the projections are reasonable would be of a highly factual nature. Assuming [redacted] met its burden of showing the reasonableness of the expenditures, the Service would most likely have to present evidence, which would presumably include various industry experts, that the projections were unreasonable even when considering the possibility of unforeseen expenditures. We think litigating such a case would be problematic and recommend not challenging the projections unless they are clearly insupportable.

It should also be noted that section [redacted] of the Tax Reform Act, as amended, requires that there be a contract and a partnership agreement outlining the expenditures to be incurred during the 8-year period starting in 1986 and ending on December 31, 1993, in order for the investors in the [redacted] to claim the credit and deductions in [redacted] for the projected expenditures. Although section [redacted] refers to a partnership agreement and a contract, it does not specify when such a contract and partnership agreement should be in place. Section [redacted] of the Tax Reform Act, before its amendment by TAMRA (quoted above), allowed an investor to claim current deductions for expenditures made to improve the [redacted] but "[redacted]." Although it is not clear, the "submission" was probably supposed to be made to the Service and attached to the taxpayer's return. It also appears that a "submission" was not supposed to be a contract or partnership agreement because there is no mention of such instruments in the statute as originally enacted in the Tax Reform Act.

Section [redacted] of the Tax Reform Act, as amended by TAMRA, does away with the "submission" requirement and, thus, no such requirement can be imposed on the investors in the [redacted]. However, one possible interpretation of the "contract and partnership agreement" requirement in the amended statute is that the drafters of the statute were referring to instruments already in existence. Under such an interpretation the Service could hold the investors in the [redacted] to the amount of the expenditures outlined in such instruments if they, in fact, existed at the time TAMRA was enacted. If such an interpretation is not viable because such instruments were not in existence at the time TAMRA was enacted, the only other possible interpretation is that Congress intended that there be a contract and partnership agreement--that would be created after the enactment of TAMRA--and if such interpretation is correct, the statute does not put any time constraints on when such instruments must be drafted.

Issue 4:

Nothing in section [redacted] of the Tax Reform Act, as amended, expressly alters the normal rules with respect to the recapture of the rehabilitation credit. Furthermore, the timing of the credit under section [redacted] of the Tax Reform Act, as amended--i.e., the credit is claimed before the property is placed in service--can be compared to the credit for "qualified progress expenditures"--such credit also being claimed before the property is placed in service. See discussion under Issue 1 above. Therefore, we think a strong argument can be made that the recapture rules for "qualified progress expenditures" should also apply here. See section 47(a)(3). Alternatively, it could be argued that the only way section [redacted] of the Tax Reform Act, as amended, works is if the expenditures are "qualified progress expenditures" under section 46(d), and, therefore, that the corresponding recapture rules expressly apply.

In this respect, it should be noted that the reasons underlying the purpose for requiring recapture of the investment credit is still present in this case and there is no indication Congress intended that the normal rules not apply. Specifically, recapture is required "[t]o guard against a quick turnover of assets by those seeking multiple credit...." S. Rep. No. 1881 87th Cong., 1st Sess. (1962), reprinted in 1962 U.S. Code Cong. & Admin. News 3304, 3320. Because the rehabilitation credit survived the Tax Reform Act, investors in the [redacted] could turn over assets to seek multiple credits. Thus, the recapture rules are still needed.

Applying the recapture rules as discussed above is also consistent with subparagraphs [redacted] and [redacted] of the Tax Reform Act, as amended. As quoted above, these subparagraphs

state that the expenditures to improve the [redacted] shall "be allocated in accordance with the partnership agreement regardless of when the interest in the partnership was acquired, except that--(i) if the taxpayer is not the original holder of such interest, no person (other than the taxpayer) had [sic; shall] claimed [sic; claim] any benefits by reason of this paragraph...." Although the meaning and purpose of these subparagraphs is unclear on their face, background materials reveal their intended purpose. Congressman [redacted] letter, discussed above, states that [redacted] had to give certain investors a rescission option so that if the proposed technical corrections to the Tax Reform Act were not to their satisfaction, they could return their partnership interests for full payment. Syndication materials issued by [redacted] discloses that some investors actually returned their partnership interests and that these same interests were then resold to new investors after the enactment of TAMRA. Therefore, it appears that these subparagraphs were intended to give the new investors the ability to take advantage of section [redacted] of the Tax Reform Act, as amended, even though they did not actually own an interest in any of the [redacted] partnerships until after [redacted]. Furthermore, the subparagraphs make clear that only the subsequent holder and not the original holder can take advantage of section [redacted] of the Tax Reform Act, as amended.

This reading of subparagraphs [redacted] and [redacted] of the Tax Reform Act, as amended, does not supersede or come into conflict with the recapture provisions under section 47 as discussed above. If any investor, including an investor who purchased an interest that was returned to one of the [redacted] partnerships under a rescission agreement, should subsequently sell his interest there is no reason section 47 should not apply. Thus, the recapture rules under section 47 are consistent with subparagraphs [redacted].

Finally, it should be noted that section 47 recapture does not apply to transfers pursuant to the death of a taxpayer. Section 47(b)(1).

Issue 5:

Section 709 expressly prohibits the deduction of organization and syndication fees with respect to partnerships. There is nothing in section [redacted] of the Tax Reform Act, as amended, that changes this rule. Furthermore, nothing in the statute prevents the Service from examining the return of [redacted] or the return of any other individual or entity involved with the rehabilitation of the [redacted]. Therefore, it is proper for the Service to examine the content of the projected expenditures to determine if any expenditures are being claimed as a deduction that should properly be capitalized.

Furthermore, organization and syndication fees are not "qualified rehabilitation expenditures" even under section [redacted] of the Tax Reform Act, as amended, and should not be included with such expenditures for the purpose of determining any investor's credit. See discussion under Issue 2 above.

Issue 6:

Treas. Reg. § 1.1016-2(a) states in part: "No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year." It is fundamental that a basis cannot be claimed with respect to costs that have been currently deducted. See Bittker and Lokken, Federal Taxation of Income, Estates and Gifts, para. 42.1. See also section 1016. Nothing in section [redacted] of the Tax Reform Act, as amended, changes this rule. Because section [redacted], as amended, allows investors in the [redacted] to deduct currently all expenditures incurred to rehabilitate the [redacted], all such expenditures may not be added to the cost basis of the [redacted]. Because such expenditures are not added to the basis of the [redacted], no basis adjustment under section 48(q) is required.

Issue 7:

For the purpose of calculating the investment credit (including the rehabilitation credit), section 46(c)(8) excludes from the basis of property or expenditures, otherwise qualifying for the credit, an amount equal to the nonqualifying nonrecourse financing for such property or expenditures. In effect, section 46(c)(8) limits a taxpayer's basis for purposes of the credit to his actual cash investments, recourse financing and qualifying nonrecourse financing for the property or expenditures.

Section 46(c)(8) applies only to property that is placed in service. Section 46(c)(8)(B)(i). In addition, three requirements must be met before a taxpayer can include nonrecourse financing in his basis for the purpose of calculating the credit. First, the property must be acquired by the taxpayer from an unrelated person. Section 46(c)(8)(D)(ii)(I). Second, any nonrecourse financing must not exceed 80% of the credit base of the property. Section 46(c)(8)(D)(ii)(II). Third, any nonrecourse financing must be "qualified commercial financing" which is, generally, financing acquired from a person regularly engaged in lending who is not related to the taxpayer. Sections 46(c)(8)(D)(ii)(III) and 46(c)(8)(D)(iv). Furthermore, a taxpayer must recapture, under section 47(d), an amount equal to the decrease in the credit due to an increase in nonrecourse

financing that does not qualify under section 46(c)(8) in any year after the property is placed in service.[6]

In this case, the rehabilitation credit was claimed in [redacted] but the property upon which the credit is based will not be placed in service until some later year and, therefore, section 46(c)(8) does not appear to apply. (The same problem exists if the expenditures at issue are treated as "qualified progress expenditures.") Although it is not clear, it appears that in this case (and in the case of "qualified progress expenditures") section 46(c)(8) should not be applied until the property is placed in service and, at that point, the recapture rules of section 47(d) should be applied. In other words, to the extent that the nonrecourse financing for the [redacted] does not meet the requirements of section 46(c)(8) in the year the property is placed in service, section 47(d) should be applied to recapture the excess credit.

Section 704(d) limits a partner's deductions to the amount of his adjusted basis in his partnership interest. Under sections 752(a) and 722, a partner's basis in his partnership interest is increased by his share of partnership liabilities. Generally, a partner's share of the nonrecourse liabilities of the partnership increases the basis in his partnership interest, as well. See Treas. Reg. § 1.752-1(e) and Temp. Treas. Reg. § 1.752-1T

Section 465 provides an additional limitation in that a taxpayer cannot deduct any amount with respect to an activity in excess of the amount that he has "at risk" in such activity. The Tax Reform Act extended section 465 to holdings in real estate. Pub. L. No. 514, 99th Cong., 2d Sess. § 503, 102 Stat. 2243 (1986). However, the 1986 amendments to section 465 apply only to holdings in real estate for "losses incurred after December 31, 1986, with respect to property placed in service by the taxpayer after December 31, 1986." Pub. L. No. 514, 99th Cong., 2d Sess. § 503(c)(1), 102 Stat. 2244 (1986). With respect to partnerships, section 503(c)(2) of the Tax Reform Act states that "[i]n the case of an interest in a...partnership...acquired after December 31, 1986, the amendments made by this section shall apply to losses after December 31, 1986, which are attributable to property placed in service by...the partnership...on, before, or after January 1, 1986." Because the losses in this case are treated under section [redacted] of the Tax Reform Act, as amended, as having been paid or incurred in [redacted] and the [redacted], or any part thereof, will not be placed in service (as rehabilitated property) until after [redacted], the 1986 amendments to

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[6] In addition, the investment credit is not limited by section 704(d) or section 465.

section 465 do not apply to these losses. Therefore, the "at risk" limitations of section 465 do not apply in this case.

Although section 704(d) can be applied before property is placed in service, the provision cannot be applied before 1993 in this case because it cannot be determined at this point whether [redacted] will incur additional nonrecourse financing before 1993. The individual investors in the [redacted] are limited partners in the [redacted] partnerships and, thus, only nonrecourse financing could increase the basis in their partnership interests. However, if [redacted] were to incur additional nonrecourse financing in the future the basis of the limited partners in the [redacted] partnerships would be increased, thereby allowing them to take greater deductions.

In this context, it should be remembered that the deductions claimed by the investors in the [redacted] in [redacted], under section [redacted] of the Tax Reform Act, as amended, were for projected expenditures for which the financing had most likely not yet been incurred by [redacted]. Therefore, Congress could not have intended to limit the deductions in [redacted] by application of section 704(d) because, otherwise, the investors could not claim the deductions in [redacted]. Because statutes must be interpreted to give them effect, as discussed above, section 704(d) should not be applied until [redacted]. At that point, section 704(d) should be applied in conjunction with the recapture provision in section [redacted] of the Tax Reform Act, as amended, to recapture any deductions for which expenditures were not actually paid or incurred and any deductions in excess of the investors' bases.

Issue 8:

It should be argued that certain dispositions of an investor's interest in any of the [redacted] partnerships will cause recapture of the rehabilitation credit, as discussed under Issue 4 above. If there is recapture under section 47, section [redacted] would not apply to recapture the credits because the Service would only require the investor to recapture the credit once. As stated above, section 47 recapture does not apply to transfers pursuant to the death of a taxpayer. Section 47(b)(1).

With respect to the current deductions claimed in [redacted], there is, arguably, no rule of recapture similar to section 47 other than the recapture provision in section [redacted] of the Tax Reform Act, as amended, and, therefore, the Service's only recourse is to recapture any excess deductions in 1993. See the discussion under Issue 10 below. In this context, it should be noted that certain arguments could be made that would require recapture of the deductions upon the disposition of an investor's

interest in one of the [redacted] partnerships. Certain arguments could also be made that would require the successor holder to recapture under section [redacted]. However, these arguments have a variety of problems and, therefore, we recommend not requiring recapture of the deductions upon the disposition of an investor's interest or from a successor investor.

With respect to investors who die before 1993, the issue of whether section [redacted] of the Tax Reform Act, as amended, can be applied is extremely problematic. We have decided not to address this issue at this time. If, however, such an issue should arise, we request that you seek our advice once again.

Issue 9:

Unfortunately, section [redacted] of the Tax Reform Act, as amended, does not appear to adopt the normal rules with respect to its utilization of the tax benefit rule. Normally, the tax benefit rule requires that a previously deducted amount be included in the taxpayer's income in the year of the recovery. And normally, section 111 allows a taxpayer to exclude from income an amount deducted in a prior year--that would otherwise be included in income under the tax benefit rule--to the extent the deduction did not reduce the taxpayer's tax liability in the prior year. Because the tax benefit rule is normally expressed in terms of inclusions in income in the year of recovery, normally the tax benefit rule requires the taxpayer to apply the applicable tax rate to the recovered income for the year in which the income is recovered.

In addition, the tax benefit rule and section 111 normally do not apply to the investment credit. See sections 47 and 111(b)(3). See Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, para. 5.7.4 (2d Ed. 1989).

However, section [redacted] of the Tax Reform Act, as amended, appears to adopt a different approach. The use of the phrase "the tax imposed by chapter 1 [for 1993]...shall be increased by the amount of the tax benefits...[received on account of the previous deductions and credits]" appears to mean that the taxpayer's income is not increased by the amount recovered but, rather, his tax liability is increased by the amount of the tax liability avoided in the previous years. In other words, this increase in tax liability would appear to be calculated based on the applicable tax rates in the years in which the benefits were claimed--i.e., [redacted] and any carryback or carryover years--rather than the applicable rates in 1993.

Therefore, the additional tax liability under section [redacted] would be the difference between the taxpayer's

tax liability without the projected expenditures that were, in fact, never paid or incurred over the taxpayer's tax liability with the expenditures for taxable year [redacted] and any year in which there was a carryback or carryforward originating in [redacted].

Issue 10:

Treas. Reg. § 301.6231(a)(3)-1(a) states that the partnership aggregate and each partner's share of "income, gain, loss, deduction, and credit of the partnership" are more appropriately determined at the partnership level. Furthermore, the regulation states that other amounts which are determinable at the partnership level with respect to partnership assets, investments and transactions and which are necessary to enable the partnership or the partners to determine the investment credit under section 46(a), recapture under section 47 or amounts at risk in any activity to which section 465 applies are also more appropriately determined at the partnership level. A recovery of deductions or credits determinable at the partnership level with respect to assets, investments or transactions of a partnership to which the tax benefit rule would apply is also more appropriately determined at the partnership level. See 885 Investment Company v. Commissioner, 95 T.C. No. 12 (1990). Therefore, any administrative or judicial proceeding which may result in an adjustment to any of these items would be conducted at the partnership level under sections 6221 through 6233. Such a determination is also binding on the partners. Section 6222(a).

These rules apply to [redacted], the [redacted] partnerships and all of their partners. The determination of the amount of expenditures actually paid or incurred from [redacted] through [redacted], that were deducted in [redacted] under section [redacted] of the Tax Reform Act, as amended, are more appropriately determined at the partnership level and, specifically on the [redacted] return for taxable year [redacted] because the assets, investments and transactions that gave rise to the deductions and credits were owned and entered into by that partnership. Furthermore, such a determination is necessary before the tax liabilities of any of the individual partners in the [redacted] partnerships can be determined.

A problem exists, however, for those investors who claimed deductions in [redacted] but who sold their partnership interest prior to [redacted]. Section 6231(a)(2)(B) states "The term "partner" means...any other person whose tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership." As with investors who remained partners in the [redacted] partnerships, a determination of which expenditures were actually paid or incurred by [redacted] will have to be made before the

tax liability of the investors who disposed of their partnership interest before [redacted] can be determined. Thus, investors who disposed of their partnership interests before [redacted] are treated as "partners" under section 6231(a)(2)(B) and will be bound by any determination made at the partnership level.

Because of the above position with respect to the definition of a "partner" for the purposes of section 6221 through 6233, we recommend issuing protective notices of deficiencies to those investors who disposed of their partnership interests prior to [redacted] for their [redacted] taxable year after the necessary determinations are made with respect to the [redacted] return of [redacted].

With respect to the rehabilitation credit claimed by investors in [redacted], if an investor has disposed of his partnership interest prior to [redacted], the recapture rules of section 47 may apply. See discussions under Issues 4 and 8 above.

For the purpose of issuing protective notices, as discussed above, and for the purpose of calculating the recaptured amount under section [redacted] of the Tax Reform Act, as amended, as discussed under Issue 9 above, we also recommend that the District Director retain the tax returns for taxable years [redacted] through [redacted] of all individual investors who claimed credits and deductions under the statute.

If you have any questions with respect to this advice, please call Lawrence S. Mannix at FTS 566-3470.

MARLENE GROSS

By: Clifford M. Harbourt

CLIFFORD M. HARBOURT
Senior Technician Reviewer
Branch 2
Tax Litigation Division